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SUBJECT: BANKERS PREDICT SOFT LANDING FOR ESTONIAN ECONOMY

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¶1. (U) Summary: Macroeconomic analysts in and out of government continue to predict Estonia faces a 'soft landing' - 6 to 8 percent GDP growth - from its period of rapid economic growth. Despite a large current account deficit, rising inflation, and a tight labor market, the long-term outlook for Estonia is good. The major Swedish banks which dominate the market here will continue to play a stabilizing role as the housing market cools, and consumer credit tightens marginally. Areas to watch include inflation, which is expected to continue rising into 2008, and Estonia's inflexible labor market. End Summary.

¶2. (U) In recent months, several factors have raised concern about a possible hard landing for Estonia's economy, which has been growing at more than 10 percent for the past two years. Wage increases of 16.5 percent in 2006 (rising to 20 percent for the first quarter of 2007), slower consumer credit growth since the beginning of 2007, devaluation fears in neighboring Latvia earlier this year, and recent cautionary reports from Moody's and other credit agencies, have all added to the debate about the direction of the Estonian economy. The cyber attacks in May on internet infrastructure, and the subsequent disruption of trade with Russia have further created an air of uncertainty. Nevertheless, analysts from both the public and private financial sector are confident that the economy will not see a sharp correction, but rather a relatively soft landing of around 6-8 percent annual GDP growth over the next two years.

Between Two Giants: Size Does Matter

¶3. (U) Estonia is often described as having a small, open economy, but Hardo Pajula of SEB Uhispank's Capital Markets Division told us the operative word should be "miniscule." To put the economy of what many refer to as "Talsinki" in perspective, he noted that Tallinn and Helsinki, Finland are basically one economic zone akin to New York City and suburban New Jersey or Connecticut. The difference here is that a balance-of-payments transaction occurs each time trade occurs between the two capitals. Much of the recent concern about potential vulnerabilities in the Estonian economy has focused on its current-account deficit, which stands now at 15 percent of GDP, but Pajula told us he is not overly concerned about this. Estonia is sandwiched between the economies of Sweden and Finland, together 36 times larger than Estonia's to the west, and that of Russia, 60 times larger to the east. Given that these much larger neighbors are both running current account surpluses of 7-10 percent of GDP, it is inevitable, Pajula said, that Estonia's economy is running a deficit.

¶4. (U) A few factors help counter this imbalance. The GOE has been running a budget surplus since 2001, and has a reputation for fiscal responsibility. Also, the national currency is pegged to the Euro and not heavily traded in currency markets. Finally, Estonia does not have a public-debt market which could

spread instability throughout the economy. Marje Josing, Director of the Estonian Institute of Economic Research, (the source agency for most raw data on Estonia's economic performance) was as sanguine as SEB's Pajula about the current-account deficit. Stressing how - in just the past 15 years - the Estonian economy has successfully weathered high unemployment and Russian "double tariffs" in the mid-1990s, the Russian currency crisis in the late 90s, and now the process of wage and price convergence with the EU, Josing said she is not worried about the long-term outlook. The heads of two Ministry of Finance (MOF) Offices (International Cooperation, and Economic Analysis) noted that Estonia has met or exceeded the IMF's goals, and Estonia's experience joining the EU could be a case study for an economic convergence. The MOF estimates that the 2007 budget surplus should be larger than the currently projected 1.9 percent of GDP, if the GOE does not decide to increase spending in a September supplementary budget.

Credit Expansion and Inflation

¶5. (U) Another frequently cited concern is the rapid expansion of consumer credit thanks in large part to a real estate boom and flexible borrowing policies (including loans via mobile phone). Many blame easy credit as another factor driving up inflation (currently 5.7 percent), and thus keeping Estonia out of the Eurozone. Annual private credit growth soared above that of peer countries from 2001-05, and in 2006 short-term interest rates averaged 3.2 percent. However, Estonia has none of the traditional monetary tools to tighten credit. The currency is pegged to the Euro at a fixed rate, and the money supply in the country is effectively controlled by Sweden's private banks. The two biggest players, Hansapank (owned by Swedebank) and SEB Eesti Uhispank together control 78 percent of the market. While loan portfolios in the Baltic countries are a fairly small share of these banks' overall exposure, they are highly profitable

ones. On July 19, SEB announced profits for the first half of 2007 were up 30 percent over the same period last year. Hansapank's Maris Lauri told us that while its parent Swedebank's assets in the Baltics represent only 10 percent of their total portfolio, they generate one-third of the company's profits.

¶6. (U) While much of this money has been pouring into real estate, that market appears to have levelled off and loan growth is now finally slowing. The Bank of Estonia reported in June that "...the credit standards of [private] banks have become stricter,...the number of customers capable of borrowing has declined and this has resulted in a fall in the number of transactions..." Officials at the Bank told us that 90 percent of households are owned by their occupants, not speculators, and banks are now charging higher interest rates for home equity loans than for initial mortgages. Non-traditional, sub-prime lenders such as the Baltic Investment Group (BIG) are still cropping up, but they represent a very small percentage of the banking market. This rapid credit growth has raised concerns that foreign banks could pull back on their position in Estonia if they began to experience a high rate of defaults, causing a disruption in the financial market. All analysts we spoke to, however, agreed that there are few scenarios in which Hansapank, SEB and the others might pull capital out of the Baltic market. It would take a major EU-wide financial shock to cause them to severely reduce their exposure here.

¶7. (U) Even with GDP growth projected to slow, and a tightening of credit by the private banks, financial experts agree that inflation has not yet peaked. The wage increases of the past year have yet to work their way through the economy, and public sector wages - typically lagging at least twelve months - have not caught up with increases in the private sector. Furthermore, noted Maris Lauri of Hansapank Markets, much of the EU structural funds slated to be spent in Estonia over the next six years will go into construction and agriculture, where they will quickly end up in the hands of consumers, driving up demand.

¶8. (U) A final area to watch is labor market flexibility. Ref A noted the tight labor market in Estonia, and the political reluctance to bring in greater numbers of foreign workers. Additionally, while Estonia ranked 17th overall in the World Bank's 2006 "Ease of Doing Business" Index, it was 151st in the specific category of "Employing Workers." Two issues accounting for this low score are the inability of workers to get flex-time or non-traditional employment contracts, and bureaucratic barriers to obtaining work visas for foreign nationals. A joint working group with representation from the Ministries of Economy (MOE) and Internal Affairs has been discussing the foreign labor issue for over a year. However, a memorandum including recommendations for simplifying the visa and immigration process for highly skilled foreign workers was adopted by the GOE only on June 14. A contact at MOE told us that the Ministry of the Interior will come up with relevant legislative proposals by November 1st, but as far as she knows there is no study currently under way.

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